AFRICA PREBRIEF

Stock Market Valuation and Economic Growth Divergence: Illusion and Delusion

An increasing amount of chatter is starting to accumulate over the supposed divergence between plummeting stock market valuations and exploding economic growth rates in frontier markets, including Africa. The implication is that Sub-Saharan African stock markets aren't keeping pace with economic growth and are therefore disappointing. The conversation is confused because a handful of basic facts aren't being established. First, stock markets and gross domestic product over time can converge in value but they measure two entirely different things. **Gross Domestic Product (GDP)** is a backward-looking indicator measuring the value of production and expenditure by individuals, businesses and governments occurring *exclusively within* a country while stock market prices measure expected future income streams of a mass of businesses operating *primarily but not exclusively* within a nation. In a region like Africa both measurements are problematic for several reasons. First, since GDP is officially defined as, "The market value of goods and services produced by labor and property in a country, regardless of nationality," it is clear that in societies where customs have long substituted for 'markets' (the use of money, formal property rights, and written contracts), economic activity of kinship-based systems that revolves around trust, barter, and oral tradition defies official detection. In that regard a country today may be described as experiencing 'growth' simply because insurance costs are now being monetized in the form of financial instruments when 'insurance' was previously, and for centuries, provided by family members utilizing barter arrangements or 'under the table' transactions. But does this transition from informal to formal activity really mean 'growth' (this is something to keep in mind for example in East Africa where the insurance sector is expected to grow exponentially see ***APB* July 6, 2011, "The British American IPO"**)? Secondly, since **Gross National Product (GNP)** was officially abandoned by the United States in 1991 an important factor more relevant in Africa and Asia than in the West is left out. GNP is officially defined as "The market value of goods and services produced by labor and property supplied by a country's residents, regardless of where they are located." Therefore, much of the wealth of expatriates of African countries picked up by GNP *is not* counted by GDP. This matters when one considers the role of the brain drain and remittances in developing African economies. With so many Africans scattered throughout the diaspora, now anxious to return home (see ***APB* September 29, 2011"Diaspora-Based Match Making (Not African Higher Education) Ends Brain Drain" and *APB* September 29, 2011 "Njambi Ngunjiri On Africa's 'Mismatch' Problem and Reversing The Brain Drain"**) or invest in domestic businesses; a reliance on measurements that leave out the full range of the brainpower, talent, skill, labor and wealth of a country is problematic. If this had been the case with **China** 20 years ago we would never have appreciated that an estimated 75 percent of mainland China's 28,000 enterprises, at that time, with significant foreign equity, were *financed by ethnic Chinese living outside China*.

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Third, stock markets require breadth and depth to serve as a proxy or barometer for expectations for the political economy and business models. Without a diverse aggregate of publicly-traded companies doing business in every corner of the country constantly feeding data back to a central point, an accurate sampling of information cannot be consistently and reliably translated into valuations. And since as **Jude Wanniski** wrote in his book *The Way The World Works* (1978), "*The most important information coming to the market is political news. War and peace, after all, can turn on the chemistry of a single mind. Political news is volatile, because it can instantly and dramatically alter the market's future income streams*," not to mention drought and famine in agricultural and commodity-based economies, Africa's nascent stock markets are especially vulnerable to wild fluctuations. It also must be noted that a bit of a self-fulfilling cycle exists. As **Charles K.D. Adjasi** of the **University of Ghana** and **Nicholas Biekpe** of the **University of Stellenbosch, South Africa** conclude in their paper, "Do Stock Markets Matter In Investment Growth In Africa?" published in ***The Journal Of Developing Areas*** (emphasis is ours): "There are two main findings from this paper; firstly stock markets returns positively and significantly influence investment growth. Therefore **increases in stock prices are indicative of lower cost of capital and availability of funds for investment.** This implies that robust stock market performance adds to capital formation for investment. Secondly, the response of investment to stock market returns increases with the level of market development across the sample. **The positive effect of stock markets on investment in Africa therefore increases as African stock markets develop further.** In particular, the significance of the interaction terms between market return and turnover ratio, and market return and value of shares traded ratio implies that as transactions costs reduce, and as liquidity, size and activity on African stock markets increase, investment becomes more responsive to stock markets. **It is important to add that the results do not suggest that less developed stock markets are highly informative and send corrective signals for investment. Rather as shown by Braun and Johnson (2005) it appears that agents and investors in Africa are aware of the information content of stock prices and take these into consideration in investment decision.** In all, results imply that despite the size, trading and liquidity constraints faced by most African stock markets, their impact on investment mobilization is significant."

Fourth it may be that there is a natural political bias *against* the formation of financial markets and at this stage, African politicians may have the upper hand over the electorate, entrepreneurs, markets and investors in slowing the movement toward deep and liquid capital markets. As **Reuven Brenner** put it *"Who can put an end to stupid policies, to government statistical lies…? Votes? Democracy? That takes quite a while, and meanwhile the mistakes compound. Financial markets force governments to react more quickly and correct their grave mistakes…Financial markets generate prices, for example, related to the probability of insolvency…These prices, exchange rates, etc. say a lot about policies pursued*." (http://www.obserwatorfinansowy.pl/2010/06/25/break-the-thermometer-and-you-will-not-have-a-fever/) We have however noted that we believe African politicians will increasingly recognize financial markets as a preferred alternative to other options necessary to address wealth distribution challenges (see ***APB* June 14, 2011, "Tullow's Ghana IPO And The Rise Of Secondary Listings In Africa")**.

Fifth and lastly, we don't think the financial market valuation-economic growth correlation can be made until GDP and total market capitalization begin to nominally converge and then one must still be careful. For example as of yesterday in the United States, home of the world's broadest and deepest market, total stock market capitalization stood at $12959.2 billion, which is about 86.4% of the last reported GDP (http://www.gurufocus.com/stock-market-valuations.php). For context, in April 2010 the total market cap of the **Nairobi Stock Exchange** was 1 trillion Kenyan Shillings (KES), which was roughly equal to $13 billion. Kenya's GDP though, was $66 billion. The **Nigerian Stock Exchange** is targeting a market capitalization of $1 trillion dollars in 2016 (http://www.voiceofnigeria.org/Nigeria/NSE-market-capitalisation-to-hit-one-trillion-by-2016.html) while its 2016 GDP is projected to be $400 billion. Currently, its market capitalization is $74 billion while 2010 GDP was $378 billion. As of 30 September 2006, the market capitalization of the **Johannesburg Stock Exchange (JSE)** was at $579.1 billion. Months ago the JSE market cap stood at $494 billion while **South Africa**'s 2010 GDP stood at $524 billion. So what does the GDP-Market Capitalization correlation cause one to interpret? Based upon the Nigerian projections which point to its outperformance of South Africa over the next 15 years, **Morgan Stanley** recommended that investors buy shares in **Guinness Nigeria Plc (GUINNESS)**, **Nestle Foods Nigeria Plc (NESTLE)**, **Diamond Bank Plc (DIAMONDB)** and **Guaranty Trust Bank Plc. (GUARANTY)** (http://www.bloomberg.com/news/2011-06-28/nigeria-s-economy-may-overtake-south-africa-by-2025-morgan-stanley-says.html). We found it odd that a construction or cement company like **Ashaka Cement** (http://investing.businessweek.com/research/stocks/snapshot/snapshot.asp?ticker=ASHAKACE:NL), well positioned to ride the inevitable infrastructure boom that logically would accompany such spectacular growth this decade was not recommended. And the fact that South Africa's market cap and GDP are near equal – unlike Nigeria's - ultimately signifies *what?* we wonder.

There are of course other variables such as currency stability, tax regimes, regulatory considerations, trade execution, a preference for debt over equity (see ***APB*** **June 1, 2011, "Kenya In The Emerging Bond Market Narrative")**, availability of Initial Public Offerings (IPOs) and increasingly more attractive investments in land and real estate projects which also help to explain the frontier stock market valuation-economic growth convergence. The primary point however that we wish to emphasize now is that the *expectation* that there is a hard and direct relationship between the two at all is dubious.

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